

**THE PARADOX OF SUCCESS:
THE ROLE OF CAPITAL MARKETS IN DETERMINING BRITISH POLICY
TOWARD THE EUROPEAN COMMON CURRENCY, 1979-1996**

A Senior Honors Thesis

by

CATON MONTGOMERY WALKER

Submitted to the Office of Honors Programs
& Academic Scholarships
Texas A&M University
in partial fulfillment of the requirements of the

UNIVERSITY UNDERGRADUATE
RESEARCH FELLOW

April 2001

Group: Economics and Political Science

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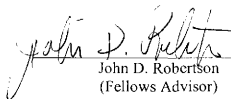
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Approved as to style and content by:


John D. Robertson
(Fellows Advisor)


Edward A. Funkhouser
(Executive Director)

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Group: Economics and Political Science

ABSTRACT

The Paradox of Success:

The Role of Capital Markets In Determining British Policy

Toward the European Common Currency, 1979-1996. (April 2001)

Caton Montgomery Walker
Departments of Economics and Political Science
Texas A&M University

Fellows Advisor: Dr. John D. Robertson
Department of Political Science

That Britain, one of Europe's largest economies, has opted not to adopt the European common currency (Euro) has puzzled students of the European Union for some time. As recent referenda demonstrate, Britons remain mysteriously cautious of monetary integration with mainland Europe. Though existing literature often attributes Britons' Euro-skepticism to nationalism or xenophobia, few have examined the role of economic concerns in determining British attitudes toward the Euro. Drawing on methodology developed by Perry and Robertson (2000), this study examines the role of capital markets in determining British attitudes toward the Euro. Specifically, using annual Euro-barometer and exchange rate data over the period 1979-1996, this study examines whether the Euro-Pound exchange rate plays a role in creating a pro- or anti-Euro political environment in Britain. Based on the assumption that, *ceteris paribus*, a pro-Euro political environment will likely result in pro-Euro policy, this study enables us to assess the effect of exchange rates on British policy toward the common currency. The study finds that, indeed, exchange rates do help shape the British political landscape – as the Euro flounders, British opinion toward the Euro sours; when the Euro outperforms the British Pound, Britons tend to acquiesce toward the notion of monetary integration.

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Introduction¹

With the official introduction of the European common currency (Euro) to the world's capital markets in 1999, Europe attained an unprecedented level of economic cohesion. In many ways, the Euro shall enable much of Europe to function as one large economy similar in scale to the United States. More importantly, the Euro's introduction also signalled a significant power shift in the world's monetary exchange markets, for the Euro represents the first threat in nearly a century to the United States dollar as the globe's most widely circulated currency. Indeed, since the dollar usurped the British Pound Sterling in the early twentieth century, the dollar has, by far, enjoyed a position as the most widely held currency. Today, the Euro – whose members currently include ten of the continent's largest economies – stands to soon make the economically cohesive Europe a monetary powerhouse.

However, many find it particularly curious that one of Europe's largest economies has, for the time being, opted not to adopt the Euro. Though many argue that the 1996 electoral success of Tony Blair's Labour party accelerated the United Kingdom's seemingly inevitable monetary convergence with mainland Europe, most Britons express reservations at accepting the common currency; as recent referenda demonstrate, Britons remain mysteriously cautious of increased economic integration. Britain's apparent Euro-skepticism has proven particularly vexing for many students of the European Union (EU). In particular, it seems that Britons have rejected their symbiotic relationship with the mainland; considering that trade with the mainland

¹ This thesis follows the style and format suggested by the Modern Language Association (MLA) of America.

represents nearly 60% (Monticelli and Papa, 1996, p. 9) of Britain's international trade, Britons' disinterest in the Euro reflects a subtle affront to the mainland's economic goals. Indeed, one may argue that Britain must adopt the Euro in order to avoid becoming a monetary has-been; similarly, the eventual success of the Euro may depend on whether it is adopted by Britain's large economy.

Naturally, Britain's aversion to the Euro raises an important question: Why do Britons seem so averse to adopting the Euro? Perhaps surprisingly, existing literature offers little empirical analysis of Britain's apparent distaste for Europe's common currency. Of the literature that does address the phenomenon, most attribute Britain's Euro-skepticism to nationalism. For instance, Anderson and Kaltenthaler (1998) claim that most Britons equate monetary convergence with a "...substantial loss of national sovereignty." (Anderson and Kaltenthaler, 1998, p. 1) Relying on nationalism to explain aversion to the Euro, one may surmise that many Britons simply prefer legal tender that sports the Queen's image. Others carry the notion of nationalism a step further, attributing British Euro-skepticism to outright xenophobia (Whitten and Bohrer, 1997, p. 2). Apparently, Britons fear foreign currency in much the same way one may fear foreign people.

However, neither nationalism nor xenophobia seems a sufficient – or even probable – explanation of Britain's aversion to monetary convergence. Switzerland – a nation without even a national language – has pursued even less integration with its European neighbors than Britain, yet no reasonable student of the European Union would attribute Switzerland's rejection of EU membership to simple nationalism.

Rather, most ascribe Switzerland's relative isolationism to economic concerns. Given Britain's history as an economic heavyweight, it seems quite reasonable to suggest that economic concerns may well play a role in determining British attitudes toward European integration.

Fortunately, the most recent literature has explored the role of British economic concerns in determining British attitudes toward the Euro. For example, Eichenberg (1998) identifies British economic performance as a primary variable in explaining British attitudes toward the European Union, specifying "...GDP, the quarterly inflation rate, and a measure of the perceived financial situation of the household as indicators of economic performance." (Eichenberg, 1998, p. 9) Very recently, the literature has explored the role of capital markets in British elections, claiming, "...currency markets have become important constraints on elected governments." (Freeman, Hays and Stix, 2000, p. 449) Though such research represents a clear departure from previous studies, none has systemically explored the role of capital markets in explaining Britain's attitude toward the European common currency.

The Process

This study portends to do just that – to explore the pivotal role of capital exchange markets in determining Britain's policy toward the Euro. Though older notions – that British Euro-skepticism may be attributed to nationalism and xenophobia – may well have merit, this study examines the role of money. Specifically, I posit that exchange rates play a significant role in determining whether or not there exists a favorable environment in Britain for adoption of the Euro – if the Euro performs poorly

relative to the British Pound, joining the Euro should seem *less* appealing to Britons; if the Euro performs strongly relative to the Pound, joining the Euro should seem *more* appealing to Britons. In essence, this study recognizes the importance of proper timing. The most important notion is not *whether* Britain adopts the common currency, but *when* Britain adopts the common currency. This study assumes that Britons indeed weigh the economic benefits of such a drastic change in monetary policy. As a result, Britons' attitudes toward the Euro may well be shaped by current economic conditions. Simply, adoption of the Euro does not represent Britons' only fear; what also concerns Britons is the prospect of a financially disastrous transition to the common currency. Herein, exchange rates play a key role in helping Britons assess current economic circumstances, for exchange rates provide a simple and quantitative method of score keeping. When comparing the Pound's performance to the Euro, Britons need not visit the mainland; daily exchange rate listings in newspapers or outside the neighborhood Bureau de Change offer an immediate assessment of the Pound's performance relative to the Euro.

Given the nature of the variables under consideration, much of the methodology utilized by Perry and Robertson (2000) seems particularly well suited to this study. Their study, which examines British party support for the European Union over much of the late twentieth century, studies the same political environment of interest to this study. Specifically, given the arguable inevitability of Britain's adoption of the Euro, an examination of capital markets must determine how exchange rates affect the political environment faced by British political elites; that is: Do the capital markets create an environment favorable to pursuing pro-Euro legislation?

As one might expect, this study accepts several assumptions first adopted by Perry and Robertson (2000). First, since I examine the political environment faced by party elites, the primary concern of this study is the group of voters to whom the party elite are most responsive – fellow party members. This assumption displays a rather intuitive notion – that party elites seek support not just from all voters, but also from certain *types* of voters. Second, this study acknowledges the existence of several tendencies within each party. Each tendency simply represents different sets of opinion among partisans. Unlike factions, tendencies are rather informal and are never institutionalized; tendencies represent “...a stable set of attitudes rather than a stable set of [partisans].” (Rose, 1980, p.269) Though informal, tendencies do necessarily precede factions. As a result, the most successful party elites must keep abreast of tendency groups among partisans.

Granted, given the myriad issues facing any leader at any given time, partisan attitudes toward the European Union may not always represent the most important issue tendencies within the British party system. Nevertheless, at a time just after the common currency’s introduction, the issue of Britain’s possible adoption of the Euro “...pose[s] real challenges not only to the politician who must navigate the very difficult waters of Britain’s continued integration into the experiment of the European Union, but to social scientists as well.” (Perry and Robertson, 2000, p. 3) Simply, British partisan attitudes toward the European Union and its common currency seem an issue British politicians cannot afford to ignore.

In the following study, I first acknowledge twelve types of voters/partisans (within Britain's two major parties) previously identified by Perry and Robertson (2000). Each type of partisan is categorized according to characteristics that align the voter/partisan to the issue of the European Union and by implication, Britain's adoption of the Euro. Each tendency is then assigned a preference order, which ranges from 1 to 12. The preference order simply indicates to what degree each tendency may benefit a politician that has as his/her policy strategy "...a clear and aggressive orientation toward further integrating Britain with the European Union." (Perry and Robertson, 2000, p.3) In this case, the preference order 12 tendency would prove most beneficial to a pro-EU leader, while preference order 1 designates the least helpful tendency. Given the current level of the European Union's development, one may well interpret "further integration" as Britain's adoption of the European Union's common currency.

This study then discusses the importance of Perry and Robertson's (2000) probability weight function (PWF). Of the twelve tendencies, each is assigned a weight "...according to how likely the tendency is to contribute to a preferred political strategy" (Perry and Robertson, 2000, p. 3) – in this case, a pro-Euro strategy. In essence, Perry and Robertson (2000) assign the weights in order to assess the likelihood of success should a party leader pursue a pro-EU (and thus pro-Euro) policy strategy; high weights signify a high likelihood of success, while lower weights suggest a low likelihood of success.

Next, the study seeks to establish whether exchange rates indeed played a role in fostering (or hindering) a pro-Euro political environment between 1979 and 1996.

Reliable data limits this study to this eighteen-year period for several reasons. Foremost, beginning in 1998, the European Union placed under embargo all Euro-barometer data used to identify the 12 types of voters/partisans. In addition, reliable exchange rate data is unavailable for years preceding 1979.² As a result, the period 1979-1996 provides the most reliable empirical exploration given the relative dearth of available data.

Issue Tendencies

The presence of several tendencies necessitates the identification of spatially ordered groups of voters within (or attached to) a political party which would prove most likely to affect the direction and momentum of the party's policy priorities. Each group should be categorized by specific attributes and attitudes that could be empirically identified. These attributes and attitudes may then define each group's position toward a general policy, enabling the placement of each group at a given location along a continuum of tendencies. These groups, regardless of their relative proximity to each other along this continuum, would nonetheless have in common some degree of commitment to a general issue (in this case, Britain's destiny in the European common currency). Here, each tendency would hold great implications for the prospects of success for pro-Euro policy.

Employing Euro-barometer surveys, Perry and Robertson (2000) empirically identify twelve tendencies within Britain's major parties (Labour and Conservative) with respect to Britain's role in the European Union and, by implication, possible

² Though the Euro was not introduced until 1999, IMF economists are able to accurately calculate the Euro exchange rate from 1979. For full citation of IMF data used, refer to Works Cited section.

membership in the European common currency. The identification of twelve different tendencies necessitates classifying voters/partisans according to three variables.

First, the respondent is evaluated according to his/her degree of partisanship – that is, how strongly the respondent associates him/herself with a particular political party. A respondent's degree of partisanship represents a primary concern of any politician. When assessing the political environment, politicians must assess the level of support for a particular policy strategy. Voters with strong partisan attachments may be easily identified as either supporters or opponents, while voters with weak partisan attachments, while susceptible to persuasion, pose for politicians a frightening area of uncertainty. In deciding whether to pursue any policy strategy, politicians must be able to assess the role of partisanship in shaping the political environment.

Second, the respondent is evaluated according to his/her attitude toward the European Union – Does the respondent appear strongly pro-EU or vehemently opposed to integration? By measuring the respondent's overall mindset regarding European unification, this second variable affords a strong indication of the respondent's attitude toward adoption of a common currency. Arguably, a voter/partisan that deplores European integration altogether is not likely to embrace a common currency. A strong supporter of integration, however, would seem most likely to champion adoption of the Euro.

Third, Perry and Robertson (2000) determine the degree of cognitive mobilization expressed by the respondent. Respondents are categorized in relative terms, earning a score of either "high" or "low" levels of cognitive mobilization. The

degree of cognitive mobilization simply measures the respondent's general awareness and grasp of the issue at hand: Do they clearly understand the Euro issue and its possible consequences? This variable proves particularly important because of the implications of a "high" or "low" level of cognitive mobilization. A respondent with a "high" score likely wields the knowledge necessary to make an informed opinion. As a result, respondents with a "high" score often prove unwavering in their stance. In contrast, respondents with "low" cognitive mobilization scores often prove easily swayed by just a bit of education; such respondents may well represent "swing votes" and thus affect a politician's tactics in a different manner than a respondent with a "high" score.

Perry and Robertson (2000) then combine respondents' replies to all three variables (partisanship, European Union affect and cognitive mobilization) in order to specify the twelve aforementioned logical tendencies.³ This process produces a spatial continuum that spans all twelve tendencies, from that which affects pro-Euro policy in a distinctly negative manner and displays "high" cognitive mobilization, to that which affects pro-Euro policy in a distinctly positive manner and displays "high" cognitive mobilization. Table 1 lists each of the twelve tendencies identified by Perry and Robertson (2000), along with their designated preference ordering (1-12).

On one extreme, the pNp tendency (partisan/national-preference) would prove most effective in hindering a pro-Euro policy strategy. Since a pro-Euro politician would perceive this tendency as least helpful to his/her policy strategy, the pNp tendency receives the lowest preference order of 1. The pUp (partisan/Union-preference)

³ Actually, this study examines 24 tendency *groups* – 12 from each of the two major parties. However, this study is concerned only with tendency *types*, of which only 12 are identified.

Table 1:
Tendencies and Their Respective Preference Order Rankings

Tendency	Preference	Attribute	Logic of Preference Ranking
pNp	1	1. Voter 2. Close to party 3. Opposed to unification 4. Disapproves of Britain's membership in EU 5. High cognitive mobilization	Partisanship enhances credibility of opposition to pro-Euro strategy and high cognitive mobilization reduces probabilities of easy co-optation. Clear opposition to EU and unification founded on high cognitive mobilization makes this voter a certain opponent of a pro-Euro strategy with virtually no reasonable possibility of consent.
pNo	2	1. Voter 2. Close to party 3. Opposed to unification 4. Disapproves of Britain's membership in EU 5. Low cognitive mobilization	Partisanship enhances credibility of opposition to pro-Euro strategy. However, low cognitive mobilization offers opportunity for co-optation. Clear opposition to EU and unification makes this partisan a certain opponent of a pro-Euro strategy, though lack of strong cognitive mobilization and partisanship offer very slight possibility of consent.
vNp	3	1. Voter 2. Not close to party 3. Opposed to unification 4. Disapproves of Britain's membership in EU 5. High cognitive mobilization	Weak partisanship reduces credibility of opposition to pro-Euro strategy, but high cognitive mobilization and opposition to EU reduce probabilities of co-optation. This voter is a near certain opponent of a pro-Euro strategy, though lack of strong cognitive mobilization and partisanship offer a very slight possibility of consent.
vNo	4	1. Voter 2. Not close to party 3. Opposed to unification 4. Disapproves of Britain's membership in EU 5. Low cognitive mobilization	Weak partisanship reduces credibility of opposition to pro-Euro strategy and low cognitive mobilization offer opportunity for co-optation. Clear opposition to EU and unification makes this voter a near certain opponent of a pro-Euro strategy, though lack of strong cognitive mobilization and partisanship offer slight possibility of consent.
vP	5	1. Voter 2. Not close to party 3. Ambivalent toward unification 4. Ambivalent about Britain's membership in EU 5. High cognitive mobilization	Weak partisanship reduces credibility of opposition to pro-Euro strategy and lack of clear position on issue of EU suggests little opposition to a pro-Euro strategy, though high cognitive mobilization suggests voter will not easily comply. This voter may be committed to a pro-Euro strategy, but lack of partisanship weakens likelihood of sustaining the consent over time.
vA	6	1. Voter 2. Not close to party 3. Ambivalent toward unification 4. Ambivalent about Britain's membership in EU 5. Low cognitive mobilization	Weak partisanship reduces credibility of opposition to pro-Euro strategy and lack of clear position on issue of EU plus low cognitive mobilization suggests resistance to a pro-Euro strategy. Lack of partisanship and apathy make this voter a reasonably high risk for sustaining consent to a pro-Euro strategy.
pA	7	1. Voter 2. Close to party 3. Ambivalent toward unification 4. Ambivalent about Britain's membership in EU 5. Low cognitive mobilization	Partisan effect plus lack of clear position on issue of EU, with low cognitive mobilization suggests little resistance to a pro-Euro strategy and offers reasonable opportunity to win compliance to a pro-Euro strategy. Apathy weakens commitment of the voter, making the voter a risky bet to offer reliable consent to a pro-Euro strategy.
pP	8	1. Voter 2. Close to party 3. Ambivalent toward unification 4. Approves of Britain's membership in EU 5. High cognitive mobilization	Partisan effect plus lack of clear position on issue of EU, with high cognitive mobilization suggests reasonable opportunity to win compliance to a pro-Euro strategy. Partisanship assumed to dominate position on Europe, thus making voter more willing to consent to a pro-Euro strategy.
vUo	9	1. Voter 2. Not close to party 3. Supports unification 4. Approves of Britain's membership in EU 5. Low cognitive mobilization	Weak partisanship and a low cognitive mobilization weakens support for a pro-Euro strategy, though clear support for EU and unification make this voter a near certain supporter of a pro-Euro strategy.
vUp	10	1. Voter 2. Not close to party 3. Supports unification 4. Approves of Britain's membership in EU 5. High cognitive mobilization	Weak partisanship weakens support for a pro-Euro strategy, though clear support for EU and unification, founded on high cognitive mobilization, makes this voter a near certain supporter of a pro-Euro strategy.
pUo	11	1. Voter 2. Close to party 3. Supports unification 4. Approves of Britain's membership in EU 5. Low cognitive mobilization	Partisanship enhances credibility of support for pro-Euro strategy. However, weak cognitive mobility suggests possible wavering on the issue. Nonetheless, clear support for EU and unification makes this partisan a near certain supporter of a pro-Euro strategy.
pUp	12	1. Voter 2. Not close to party 3. Supports unification 4. Approves of Britain's membership in EU 5. High cognitive mobilization	Partisanship, high cognitive mobilization and clear support for EU make this partisan a certain supporter of a pro-Euro strategy that is unlikely to waver.

Source: Perry and Robertson (2000), Table 1.

tendency represents the other extreme. Given its support of European integration, pro-Euro politicians would perceive the pUp tendency as the most helpful in pursuing pro-EU policy, and it thus receives the highest preference order of 12. All other tendencies (those with preference orders 2-11) reflect voters/partisans with lower levels of cognitive mobilization and weaker opinions regarding European integration. While those closest to pUp (for example, 8-11) generally support a pro-EU strategy, those closest to pNp (for example, 2-4) generally oppose a pro-EU strategy. Partisans in the middle (for example, 5-7) remain relatively apathetic with respect to European integration.

Preference order rankings matter because they directly impact politicians' assessment of the political environment. For example, should a pro-Euro politician notice a heavy presence of anti-EU tendencies (for example, tendencies with rankings ranging from 1-4), that politician would be able to ascertain with certainty that a pro-Euro policy strategy would not be prudent considering the anti-integration political environment. More than anything, preference order rankings offer the pro-Euro politician a method of score-keeping; while a high score (a heavy presence of pro-EU tendencies close to 12) would signal an opportunity to actively pursue pro-Euro policy, a low score (signified by a heavy presence of anti-EU tendencies close to 1) would suggest a time for the politician subdue his/her pro-Euro fervor. Simply, preference order rankings make it possible to quantify the politician's perception of the political environment, a perception that indubitably affects the politician's strategies and behavior.

Weights

In many ways, the British model of parliamentary democracy initiated modern notions of representative government. For centuries, Britain's parliamentary institution has ensured relative stability for the nation and, as a result, most Britons hold the system in high esteem. Indeed, Britain has developed a sort of "...cultural affinity to parliamentary sovereignty." (Perry and Robertson, 2000, p. 12) Naturally, modern ideals of European integration represent a significant adjustment to the Parliament's sovereign powers. By definition, adopting a Europe-wide common currency would require that British officials relinquish a great deal of control over monetary policy. Adoption of the common currency appears an issue with which any pro-Euro politician must tread lightly.

As a result, any pro-Euro politician must always gauge the possible consequences of pursuing such a risky policy strategy. Here, application of Perry and Robertson's (2000) probability weight function (PWF) proves particularly relevant. Actually, each of the twelve tendencies receives two "weights". First, each tendency receives the preference order ranging from 1 to 12. Second, each tendency is given a value weight (VW) ranging from 0 to 1. The two different weights differ in that preference orders simply identify which of the tendencies would prove most (or least) beneficial to a pro-Euro politician's policy strategy, while value weights predict to what extent each tendency would help further a pro-Euro politician's policy strategy. The formula used to calculate the value weight of each tendency may be represented as:

$$\text{Value Weight (VW}_i\text{)} = [P_i - (P_i/11)]^{1/2},$$

where P_i represents the non-weighted preference order of the respective tendency (i.e., $pNp=12$ and $pUp=1$).⁴ (Perry and Robertson, 2000, p. 17)

The formula above produces a value weight for each tendency, ranging from 0 to 1. Each tendency is weighted according to the degree to which it contributes to pro-Euro policy. Since the tendency represented by pNp would not contribute toward pro-Euro policy in any way, the tendency receives a value weight of 0. Conversely, the tendency represented by pUp would contribute a great deal toward pro-Euro policy, and thus receives the highest value weight of 1. All other tendencies receive value weights less than 1 and greater than 0.⁵

Since the probability weight function considers the effects of both weights, the probability weight function (PWF) represents the product of the two weights:

$$PWF = P_i (VW),$$

where P_i denotes the preference order value for each tendency (1-12, see Table 1 and Figure 1), VW is the value weight assigned to each tendency and PWF represents the probability weight function assigned to each tendency. (Perry and Robertson, 2000, p. 23). Therefore, the pUp tendency (and each voter/partisan therein) has a weighted probability of 12 (the product of 12×1), while the pNp tendency receives a weighted probability of 0 (1×0). All other tendencies garner weighted probabilities between 0 and 12. Table 2 lists the probability weight functions for each of the twelve tendencies.

⁴ Refer to Table 1 for P_i values of all tendencies.

⁵ See Table 2 for a complete listing of each tendency's value weight (VW).

Table 2:
Probability Weight Function and Value Weight by Tendency

Tendency	P_i	VW	PWF
pNp	1	0	0
pNo	2	.30151	.60302
vNp	3	.4264	1.2792
vNo	4	.52223	2.08892
vP	5	.60302	3.0151
vA	6	.6742	4.0452
pA	7	.73855	5.16985
pP	8	.79772	6.38176
vUo	9	.8528	7.6752
vUp	10	.90453	9.0453
pUo	11	.95346	10.48806
pUp	12	1	12

Source: Perry and Robertson (2000), Table 2.

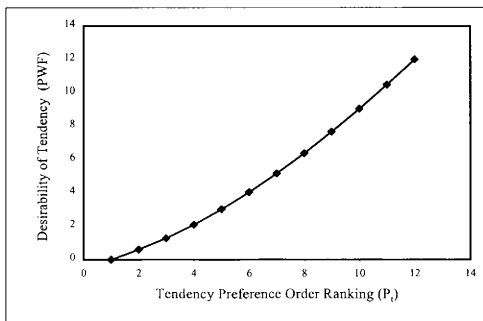


Figure 1: *Probability Weight Functions and Preference Order Rankings*

Source: Perry and Robertson (2000), Figure 1.

Given the nature of this study, the probability weight function proves invaluable since both weights must be taken into account. Simply, each of the two weights measures a distinct component that helps to create a particular political environment. The first weight – preference order ranking – indicates which of the twelve tendencies a politician most (or least) prefers to deal with in pursuing a particular policy strategy. In this case, pro-Euro politicians most prefer the presence of tendencies with preference rankings close to 12; such tendencies form a strong support base for pro-Euro policy. Conversely, the pro-Euro politician least prefers tendencies with preference order rankings closest to 1; such tendencies form a strong base of opposition to pro-Euro policy. Simply put, preference order rankings measure to what degree a pro-Euro politician would prefer the presence of each tendency.

However, the second weight – the value weight (VW) – measures another phenomenon altogether. In essence, the value weight measures the prospect of pro-Euro policy not from the perspective of the politician, but from the standpoint of the tendency itself. Specifically, the value weight assesses to what degree each tendency would contribute to promoting pro-Euro policy. Naturally, the tendency that most strongly opposes European integration would not promote pro-Euro policy in any way. As a result, it receives a value weight of 0. Conversely, the most pro-EU tendency receives the highest value weight of 1 since it seems most likely to promote pro-Euro policy. Basically, value weights gauge to what degree each tendency helps to promote pro-Euro policy.

Indeed, each of the two weights measures a distinct component that helps to create a particular political environment. In this study's quest for a pro-Euro political environment, the probability weight function offers particular insight to the likelihood of pro-Euro policy by combining the effects of both the preference order rankings and value weights. In particular, the probability weight function affords the study a quantitative assessment of the political environment.

Findings and Analysis

The existence of the probability weight function proves essential in assessing the role of capital markets on pro-Euro policy in Britain. Specifically, the availability of two quantitative variables – exchange rate data and the probability weight function – makes it possible to empirically evaluate the merit of an essential premise: that capital markets play a role in shaping tendencies, which then contribute to the overall political environment in Britain. In turn, the political environment determines the likelihood of politicians pursuing a pro-Euro policy strategy.

Based on this premise, a first hypothesis emerges: that exchange rates indeed play a significant role in creating a pro- or anti-Euro political environment in Britain. By helping to shape the tendencies with the two major British parties, exchange rates indirectly determine whether or not pro-Euro politicians are able to confidently pursue a pro-Euro policy strategy.

However, this first hypothesis requires a bit of refinement. Specifically, the time period under investigation – 1979-1996 – demands that we consider the effects of the European Union's development on British partisans' perceptions. The period 1979-1996

represents a period of dramatic development for the European Union. As a result, this study must consider the effects of European Union milestones. For example, the year 1986 represents a pivotal year in the development of the European Union. In 1986, Britain, along all other members of the European Union, reached an accord with the Single European Act. By any measure, the Single European Act heralded a clear acceleration in the development of the European Union. For many Britons, the Single European Act's passage cemented the notion that European integration (which would culminate in the introduction of a common currency) was poised to take the leap from an ideal to a reality. The Single European Act's passage left an indelible mark on all Britons. As one scholar notes, "In retrospect, the years 1986 and 1987 resemble the eye of the storm, ...succeeded by a rapid acceleration of European integration." (Dinan, 1999, p.121) If indeed the process of European integration may be described as a "storm", little doubt the events of 1986 left Britons acutely aware of the implications of European integration and of the European Union's ultimate goal of adopting a common currency.

It follows that the importance of the Single European Act's passage necessitates a second hypothesis: that we should expect exchange rates to play a even greater role in creating a pro- or anti-Euro political environment after 1986. If indeed 1986 represents a quantum leap in European integration (in which eventual creation of a common currency had always been a primary goal), it should emerge as a year after which the implications of a common currency became a particularly salient issue for Britons.

In order to evaluate the two aforementioned hypotheses, I first isolate the exogenously determined (independent) variable – the exchange rate. Using exchange rate data provided by the International Monetary Fund (IMF), the exchange rate of interest tracks how many European Currency Units (ECU's, or Euros) one would receive in exchange for one British Pound on open capital markets. (i.e., the ECU/Pound ratio) Though the IMF records exchange rate data on a monthly basis, the Euro-barometer data utilized by Perry and Robertson (2000) is available only on an annual basis. As a result, I calculate the mean *annual* exchange rate for each of the 18 years in question (See Table 3 for annual values). This manipulation of the data – using monthly values to calculate an annual value – proves particularly essential; to obtain usable results, the study must express both exchange rate data and Euro-barometer data in comparable units.

Data provided by Perry and Robertson's (2000) methodology also requires a bit of manipulation. Using the same Euro-barometer survey data, this study requires that we ascertain the political environment over the entire year. In any given year, there exist a total of 24 tendency groups – 12 from each of the two major political parties. In order to determine the level of pro-Euro support during each year among the two parties, we must first determine whether the distribution of voters/partisans helps to create a pro- or anti-Euro environment.

If, for example, a large portion of the voters/partisans makes up the pUp tendency, then we may expect a relatively pro-Euro political environment. On the contrary, if most voters/partisans compose the pNp (and other anti-European Union)

tendency, we may expect a decidedly anti-Euro political environment. In order to determine the proportion of the voters/partisans that prefer pro- or anti-Euro policy, we calculate the proportion of voters/partisans that make up each tendency. That is, we divide the number of voters/partisans in each tendency by the sum of all voters/partisans in each party. This produces a percentage for each tendency. We then multiply this percentage (or share of voters/partisans that occupy each tendency) by the probability weight function for each tendency. We then sum these products for each of the 24 tendency groups. The sum for each year yields variable S ,⁶ which provides particular insight into the political environment of each year. A relatively high S would indicate that a large share of voters/partisans were categorized among pro-European Union (and thus pro-Euro) tendencies. Conversely, a relatively low S would indicate that a large share of voters/partisans harbored anti-European Union (and consequently anti-Euro) sentiments. The S values for each of the 18 years in question are depicted in Table 3.⁷

Next, annual S values are plotted against the annual exchange rate over the period 1979-1996. Though such a test may appear relatively simple, the range of relevant tests was limited largely by the availability of reliable data. For example, the relatively small number of years in question ($N=18$) hampered the reliability of time-series analyses. However, the test utilized proves particularly relevant because it portrays the direct effect of exchange rates in determining the level of pro- or anti-Euro

⁶ For an example of S value calculation, see Appendix: Calculation of S Value.

⁷ Euro-barometer data was not available for the years 1980, 1990, 1991, or 1995. As a result, the S -values for each of these years were extrapolated by finding the mean of the S -values of the years immediately before and after. For example, the S -value for 1980 equals the mean of the S -values for 1979 and 1981.

Table 3:
Average Annual Exchange Rate and S Value by Year

Year	Average Annual Exchange Rate (ECU/Pound Ratio)	S Value
1979	1.568	1.400458
1980	1.688	1.406065
1981	1.818	1.411671
1982	1.780	1.351439
1983	1.711	1.492564
1984	1.686	1.464565
1985	1.703	1.453156
1986	1.485	1.458315
1987	1.418	1.503874
1988	1.511	1.421597
1989	1.476	1.551687
1990	1.402	1.459964
1991	1.425	1.414102
1992	1.354	1.368240
1993	1.283	1.436062
1994	1.288	1.379923
1995	1.203	1.360545
1996	1.283	1.341166

support among British voters/partisans. Results are depicted in Figure 2.

Should the hypothesis hold credence, we should seek a certain relationship: as the Euro performs poorly relative to the British Pound, joining the Euro should seem *less* appealing to Britons; if the Euro performs strongly relative to the Pound, joining the Euro should seem *more* appealing to Britons. In other words, we may expect an increasing *S* value during periods in which ECU/Pound ratio decreases, and a decreasing *S* value during periods in which ECU/Pound ratio increases; that is, we expect to notice an inverse relationship between *S* and the ECU/Pound ratio.

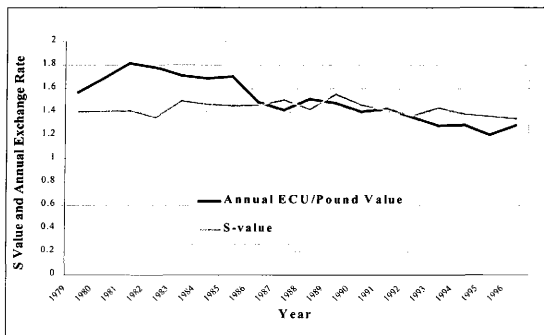


Figure 2: Annual Exchange Rate and S values for the Period 1979-1996

Though early years (at left in Figure 2) fail to depict a clear relationship, the year 1986, which heralds adoption of the Single European Act, clearly represents a pivotal turning point. Indeed, in the right-hand portion of Figure 2 (which depicts the period after 1986), a decidedly inverse relationship appears as predicted. As the Euro flounders with respect to the British Pound, causing the ECU/Pound ratio to increase, support for European integration dwindles, causing the S value to decrease, and vice versa. Without a doubt, passage of the Single European Act initiated an era in which Britons began to assess their economic situation in an unprecedented manner.

Indeed, findings suggest that both hypotheses hold credence. First, a clearly inverse relationship has emerged between the Pound's success and pro-EU sentiments in Britain. When the Pound outperforms the Euro, Britons become disinterested in

increased integration with mainland Europe; when the Euro exhibits potential for success, Britons begin to acquiesce with respect to increased monetary integration. Without a doubt, whether or not the average voter/partisan actively follows exchange rates, capital markets exert real influence in creating a pro- or anti-Euro political environment in Britain.

Second, and perhaps more importantly, the role of capital markets in shaping the British political environment becomes strikingly obvious after passage of the Single European Act in 1986. As European integration developed from a mere notion to an inevitability during the mid-1980's, exchange rates began to play an indelible role in molding the British political landscape.

Conclusion

While this study has demonstrated that capital markets exert a great deal of influence in shaping the pro- or anti-Euro political environment in Britain, the role of Britain in the European common currency shall no doubt continue to pester British politicians for years to come. Though both of Britain's major parties recognize that Britain will remain an important member of the European Union (Perry and Robertson, 2000, p. 28), the *degree* of further integration – specifically, Britain's adoption of the Euro – remains a mystery.

Nonetheless, based on this study's results, one may reasonably assume that any policy strategy designed to move Britain in the direction of adopting the European Union's common currency will in no small part depend upon the performance of the Euro relative to the Pound on the world's capital markets. In an era of globalization, in

which governments are increasingly held accountable by all things financial, it comes as little surprise that global capital markets should wield a heavy hand in shaping Britain's role (or lack thereof) in Europe's most recent monetary experiment.

Perhaps surprisingly, the influence of capital markets presents the pro-Euro British politician with a curious paradox: though the average voter stands to gain from a strong British Pound, the strong Pound has surfaced as an essential factor in creating an anti-Euro political environment. As a result, the pro-Euro politician must choose between perceived long-term prosperity (as a member of the common currency) and a certain degree of short-term suffering (caused by a weak Pound), which may very well cost the pro-Euro politician re-election. In essence, the Pound's success represents pro-Euro policy's failure. It is this paradox of success that the pro-Euro British politician must navigate for the foreseeable future. Most importantly, it is this paradox of success that will play an indelible role in determining Britain's future role in the European experiment of monetary integration.

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APPENDIX: CALCULATION OF S VALUE

The probability weight function (PWF) values calculated by Perry and Robertson (2000) require manipulation in order to assess the effect of the ECU/Pound ratio (annual exchange rate) on the pro- or anti-Euro political environment in Britain.

Table A-1 tracks the calculation of S for 1979. As described in the text, we calculate a share of party (δ) value in order to determine the percentage of each party's membership that makes up each of the 12 tendencies. This δ value is then multiplied by the PWF value to reflect the relative presence of each tendency, producing $[PWF \times \delta]$ values shown at right below. Then, the sum of all $[PWF \times \delta]$ values from both parties is calculated to produce an S value, shown at bottom right in bold type. S values for all other years (1980-96) are calculated using the same procedure.

Table A-1:
Calculation of S Value

Party	P_i	PWF	Tendency	Number of Voter	Share of Party (δ)	$PWF \times \delta$	S Value
Labour	1	0	pNp	10	0.031646	0	
Labour	2	0.30151	pNo	29	0.091772	0.02767	
Labour	7	0.73855	pA	35	0.110759	0.081801	
Labour	8	0.79772	pP	32	0.101266	0.080782	
Labour	11	0.95346	pUo	8	0.025316	0.024138	
Labour	12	1	pUp	25	0.079114	0.079114	
Labour	3	0.4264	vNp	16	0.050633	0.02159	
Labour	4	0.52223	vNo	40	0.126582	0.066105	
Labour	6	0.6742	vA	53	0.167722	0.113078	
Labour	5	0.60302	vP	28	0.088608	0.053432	
Labour	9	0.8528	vUo	16	0.050633	0.04318	
Labour	10	0.90453	vUp	24	0.075949	0.068698	
Conservative	3	0.4264	vNp	13	0.038235	0.016304	
Conservative	4	0.52223	vNo	35	0.102941	0.053759	
Conservative	6	0.6742	vA	44	0.129412	0.087249	
Conservative	5	0.60302	vP	38	0.111765	0.067396	
Conservative	9	0.8528	vUo	26	0.076471	0.065214	
Conservative	10	0.90453	vUp	46	0.135294	0.122378	
Conservative	1	0	pNp	7	0.020588	0	
Conservative	2	0.30151	pNo	10	0.029412	0.008868	
Conservative	7	0.73855	pA	21	0.061765	0.045616	
Conservative	8	0.79772	pP	27	0.079412	0.063348	
Conservative	11	0.95346	pUo	29	0.085294	0.081325	
Conservative	12	1	pUp	44	0.129412	0.129412	1.400458

VITAE

Caton Montgomery Walker
1527 DeCharles
Tyler, TX 75701

Education:

Texas A&M University (TAMU)

Class of 2001

Double Major: B.S. Economics, B.S. Political Science; Minor: Spanish

Honors: Graduated Magna Cum Laude; GPA overall: 3.88; GPA in Major(s): 4.0

TAMU Honors degree recipient, Texas A&M Honors Program

Various Honors Societies, including Golden Key and Phi Kappa Phi

TAMU Honors Program Undergraduate Research Fellow (2000-2001)

Recipient, TAMU Economics Department Neal Hahn Merit Scholarship (2000-2001)

College of Liberal Arts Student Council President (2000-2001)

College of Liberal Arts Committee Positions:

College of Liberal Arts Diversity Committee (2000-2001)

College Representative, Study Abroad Scholarships Committee (1999-2001)

College Representative, TAMU Academic Standards Committee (1999-2000)

Boston University

Boston University London Liberal Arts Program, summer 1999

Boston University Madrid Internship Program, summer 2000

Professional Experience:

Private Enterprise Research Center, Texas A&M University

Student Worker: Editorial and Research Assistant, September 1999 – May 2001

Revised, proofread material for: submission to academic journals, book publication

Assisted with research activities via data summarization, source retrieval

Fundesdo (Foundation for Sustainable Development), Madrid, Spain

Intern, summer 2000

Evaluated costs of projects, presented spending proposals to project managers

Advised project managers on incorporation of information technology in projects

Consolidated database of potential employees

Tyler Economic Development Council (TEDC)

Intern, summer 1998

Researched trends in Economic Development (ED)

Conducted survey of potential ED prospects

Provided 1998 updates for annual publications

Conducted various research related to operations, strategic planning of TEDC

University of Texas at Tyler

Research Assistant: summer 1997, summer 1999

Compiled, analyzed data for regional Labor Market Survey